

Outlook for Financial Markets

Down, but not out!

"In the middle of every difficulty lies opportunity."

– Einstein

Earnings season recap

Our positive 2019 market outlook is built on the notion of solid, though slower, U.S. economic growth. While there is certainly no shortage of risks to consider (trade negotiations, government shutdowns, Brexit, etc.), our base case is that the economy will persevere on the back of a strong consumer and continued positive fiscal boost. Against this backdrop, corporate earnings, a primary stock market driver, should also deliver slower growth, but steady results. With the majority of fourth quarter 2018 earnings season now on the books, it is evident that this has indeed been the case. In fact, stock price reaction to earnings has been better than that seen in recent periods, suggesting investor expectations were too low.

Throughout the first three quarters of 2018, a strong economy coupled with 2017 tax law changes propelled earnings higher by over 20% for S&P 500 firms (*Exhibit 1*). Despite these impressive results, estimates for fourth quarter earnings began to decline since peaking in the July to October time frame. At one point analysts were expecting fourth quarter earnings growth of 20.2%, which was subsequently revised down to a still-respectable 16.2%.

Since the mid-January low point, however, estimates have staged a rebound as results came in better than feared (*Exhibit 2*).

The number of companies reporting earnings per share above analyst estimates this quarter was in line with historical trends at 71%. The average earnings beat came in at 3.3% above estimates, and stock price responses to positive results registered a strong 1.4% average two-day increase. This is well above the 1% reaction seen over the last 5 years. Even companies that missed expectations saw their share value rise an average of 0.2%, versus the typical 2.6% drop. Investor sentiment, it seems, had undeniably fallen too far too fast.

On a sector basis, Energy was a standout as S&P 500 Energy firms registered an average result 17.8% above expectations, smashing through estimates that had been consistently lowered over the past several months. Energy companies are now being managed much more efficiently, allowing for increased production at lower break-even costs, helping mute the impact of the late 2018 oil price decline. Industrial, Consumer Discretionary and Health Care companies also exceeded revenue expectations by at least 1% (with more upside on earnings).

Fourth quarter results also affirmed that consumers remain in a strong position, as

Executive Summary

Fourth quarter earnings season delivers solid results

Strong price reactions to positive announcements suggest sentiment had drifted too low

Slow and steady growth theme for 2019 remains intact

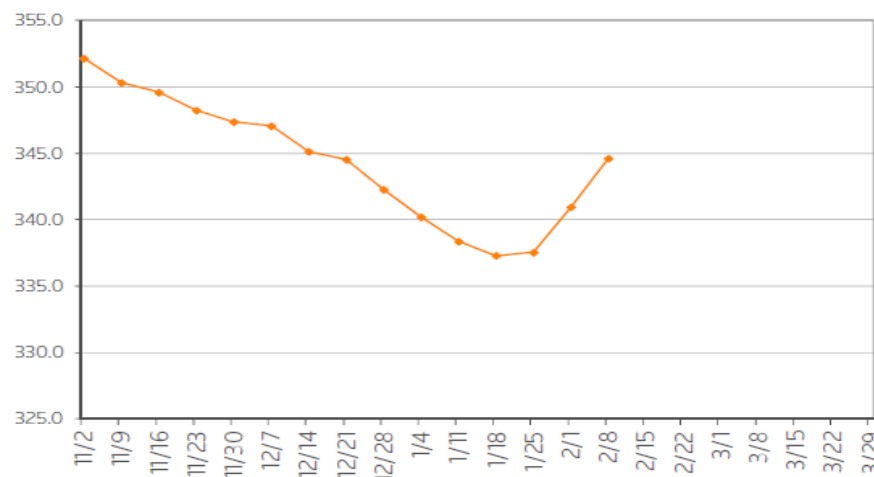
Government shutdown impact more likely political than economic

Exhibit 1 » Earnings spiked in early 2018 creating tough comparisons for the next year

Historical/Current/Future Earnings Growth Rates

Sector	Historical					Projection			
	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4
Consumer Discretionary	11.5%	18.8%	21.5%	25.4%	14.5%	-1.4%	7.2%	9.9%	15.5%
Consumer Staples	12.1%	13.1%	13.9%	11.4%	4.1%	0.9%	3.0%	3.8%	6.5%
Energy	120.4%	88.7%	124.0%	114.2%	78.8%	-10.0%	-8.8%	-16.7%	-9.4%
Financials	14.6%	30.7%	27.5%	44.8%	16.9%	4.9%	7.0%	8.1%	19.0%
Health Care	9.1%	16.2%	18.4%	16.5%	12.8%	6.2%	3.4%	5.4%	10.1%
Industrials	1.8%	24.8%	20.2%	18.9%	27.0%	6.0%	9.0%	11.6%	13.3%
Materials	35.9%	39.4%	40.6%	30.1%	2.1%	-11.3%	-5.3%	0.1%	10.2%
Real Estate	-4.1%	3.1%	3.3%	5.3%	6.3%	2.7%	3.3%	4.6%	6.7%
Technology	23.6%	31.8%	29.0%	29.1%	9.2%	-6.0%	-4.7%	-2.5%	7.6%
Communication Services	4.6%	32.1%	26.1%	26.1%	26.0%	-4.2%	18.1%	1.2%	3.2%
Utilities	13.0%	16.4%	10.9%	10.9%	-10.9%	0.7%	2.6%	3.7%	17.6%
S&P 500	14.8%	26.6%	28.4%	28.4%	16.2%	0.1%	3.6%	3.2%	9.8%
S&P 500 Ex-Energy	12.7%	24.5%	25.0%	25.0%	13.6%	0.6%	4.3%	4.5%	11.0%

Source: I/B/E/S data from Refinitiv

Exhibit 2 » Estimate revisions recently began to reverse
S&P 500: Q4 2018 share-weighted earnings (\$B)

Source: I/B/E/S data from Refinitiv

sales growth for Consumer Discretionary companies came in at a healthy 5.2% clip. Some positive consumer-related highlights include Starbucks and Disney, with Starbucks' same-store sales growth surging 4% as customers bought more per visit, and 5% higher spending at theme parks contributing to Disney's revenue growth.

In addition to the published financial reports, quarterly conference calls provide valuable insight into current conditions and future trends. They offer both company-specific details, and a bottom-up assessment of the economy. In particular, this quarter we paid close attention to executive comments related to our three big themes for 2019: the Fed/interest rates, Chinese economic growth, and trade/tariffs. On the interest rate front, Citigroup did suggest that fourth quarter rate uncertainty caused some customers to postpone investment decisions, but believes recent Federal Reserve clarity will prevent this hesitation from spilling into a broader economic malaise.

Expected interest rates also drive foreign exchange (FX) rates. Dollar strength was a drag for multinationals in the second half of 2018, and cited as an incremental headwind for 2019. Mondelez, for example, which has around 40% of sales in emerging markets, reported a 1.4% drag on sales due to FX movements in 2018, and expects a negative currency impact of 3% this year. As the Fed is now on hold from raising rates in the near term, the U.S. dollar should stabilize, thereby reducing the currency impact for multinationals. Of course, multinational companies also face the prospect of China's waning growth and a diverse set of firms have confirmed disappointing results in that region. 3M is an example here, where fourth quarter sales were flat in China, which is well below the double-digit growth rates reported in the last few quarters. Recent stimulus measures by the Chinese government should stabilize growth going forward, so we expect marginal improvement on this front later in 2019.

The past few weeks have also brought confirmation that the ongoing tariff negotiations are causing disruptions across multiple industries. Before the holiday, retailers accelerated imports in an attempt to delay tariff costs. More recently, Hyundai's COO for North America stressed the need for resolution so they can complete pending supply chain adjustments, confirming that capital investment decisions are subject to the outcome of trade negotiations.

Looking forward

Earnings growth is expected to decelerate to the low single digits for the next few quarters ([Exhibit 1](#)). A big portion of the slowdown is due to difficult comparisons created by the aforementioned corporate tax cuts. Energy is notable due to its rapid reversal from huge year-over-year earnings gains to projected declines based on lower oil price expectations (which can be volatile and lead to quick reversals). Information Technology company earnings

are also expected to dip, given above-average China exposure, a down cycle for semiconductors, and weaker smartphone sales.

For 2019, consensus expectations currently forecast 4.4% earnings growth. While down from 2018 levels, this falls directly in line with our "slow and steady" expectations for the year. On a positive note, the relatively low level of forecasted growth provides an easier hurdle to beat. Furthermore, after the market selloff, the forward P/E ratio for the S&P 500 is at 15.9x, which remains slightly below the 20-year average, allowing room for expansion.

A note on the shutdown

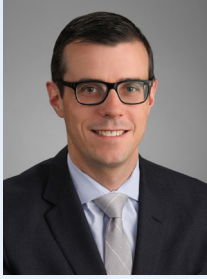
Last month brought to a close the longest shutdown in U.S. government history, and many clients have inquired about its impact. From a purely economic perspective, the episode is likely to have minimal lasting repercussions. Yes, it will shave a few tenths of a percent from Q1 GDP growth, but some of that should be made up for in future quarters as back pay is issued. The more lasting effect will be seen on the political stage. From our perspective, it was always curious that President Trump chose to link a government shutdown to a controversial immigration issue. Shutdowns tend to be universally disliked, and by taking ownership for this one the president handed Democrats negotiating leverage that gave little incentive to compromise.

In the end, facing a possible mass exodus on the issue from his party, the president was forced to throw in the towel. After winning this high-profile battle, Democrats may now feel more confident in future standoffs, which could lead to further gridlock on key budget issues. It is also plausible that President Trump understands his position, and may be willing to more seriously consider compromise on select initiatives. Infrastructure is one area where common ground may be found, suggesting the odds of a deal have gone up. There is also speculation that the shutdown loss will lead the president to seek a quicker win on trade with China. This aligns with his softening rhetoric on the topic over the last few weeks, but any deal that fails to address intellectual property theft and corporate access may not be viewed as a win at all.

Michael Stritch, CFA®
Chief Investment Officer &
National Head of Investments
BMO Wealth Management - U.S.

Yung-Yu Ma, Ph.D.
Chief Investment Strategist
BMO Wealth Management - U.S.

Glenna K. Anderson, CFA®
Manager, Equity Research
BMO Wealth Management - U.S.



Michael Stritch, CFA®
Chief Investment Officer &
National Head of Investments
BMO Wealth Management - U.S.

As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our

clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



Yung-Yu Ma, Ph.D.
Chief Investment Strategist
BMO Wealth Management - U.S.

As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

Dr. Ma earned his Ph.D. in Finance at the University of Utah and his B.A. in Economics and Political Science, *magna cum laude*, at Williams College.

Yung-Yu lives in Portland, Oregon with his wife and two children. He is a basketball fan and enjoys cheering on his children's teams.



To view this piece, and other articles online, please visit us at wealth.bmoharris.com/insights/



Corporate Office: 111 W. Monroe Street, Chicago, IL 60603

If you no longer wish to receive email messages promoting or advertising our products or services, please reply to the email with the words 'Opt Out' in the subject line, and we will process your request. Please allow ten business days to process your request. Please note that even if you choose not to receive email messages promoting or advertising our products or services, you may continue to receive information specifically related to your BMO Harris Bank N.A. accounts.

BMO Wealth Management is a brand name that refers to BMO Harris Bank N.A. and certain of its affiliates that provide certain investment, investment advisory, trust, banking, securities, insurance and brokerage products and services.

Investment Products are: **NOT FDIC INSURED - NOT BANK GUARANTEED - NOT A DEPOSIT - MAY LOSE VALUE**

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

Securities, investment advisory services and insurance products are offered through BMO Harris Financial Advisors, Inc. Member FINRA/SIPC. SEC-registered investment adviser. BMO Harris Financial Advisors, Inc. and BMO Harris Bank N.A. are affiliated companies.

Securities and insurance products offered are: **NOT FDIC INSURED - NOT BANK GUARANTEED - NOT A DEPOSIT - MAY LOSE VALUE.**

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

BMO Private Bank may have a material fiduciary, lending, or other banking relationship with any Company mentioned above or any of their affiliates, however, applicable laws, regulations and policies prohibit the disclosure of such relationship to employees who are not directly involved, as well as external disclosure without client consent.

The research analysts who contributed to this report do not know if BMO Harris Bank N.A. or its affiliates have any significant relationship with any Company mentioned above. BMO Capital Markets, an affiliate of BMO Harris N.A., may from time-to-time engage in underwriting, making a market, distributing or dealing in securities mentioned herein.

Please consult with your advisor for your own personal situation. The research analysts contributing to the report have certified that:

- All the views expressed in the research report accurately reflect his/her personal views about any and all of the subject securities or issues; and
- No part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by him/her in this research report.

The information and opinions expressed herein are obtained from sources believed to be reliable and up-to-date; however, their accuracy and completeness cannot be guaranteed. Opinions expressed reflect judgment current as of publication and are subject to change.

Past performance is not indicative of future results. International investing, especially in emerging markets, involves special risks, such as currency exchange and price fluctuations, as well as political and economic risks. There are risks involved with investing in small cap companies, including price fluctuations and lower liquidity. Commodities may be subject to greater volatility than investments in traditional securities and pose special risks. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, and international economic and political developments.

"BMO Wealth Management" is a brand name that refers to BMO Harris Bank, N.A., BMO Family Office, LLC, BMO Harris Financial Advisors, Inc., BMO Delaware Trust Company, and certain affiliates that provide certain investment, investment advisory, trust, banking, securities, insurance and brokerage products and services. "BMO Family Office" is a brand name that refers to BMO Harris Bank, N.A., BMO Family Office, LLC, and BMO Delaware Trust Company. The BMO Family Office brand provides family office, investment advisory, investment management, trust, banking, deposit and loan products and services. These entities are all affiliates and owned by BMO Financial Corp., a wholly-owned subsidiary of the Bank of Montreal. Capital Advisory Services are offered by a division of BMO Harris Bank, N.A. Member FDIC.

Family Office Services are not fiduciary services and are not subject to the Investment Advisors Act of 1940 or the rules promulgated thereunder.

Capital Advisory Services are offered by a division of BMO Harris Bank N.A.

NMLS # 401052

Securities, investment advisory services and insurance products are offered through BMO Harris Financial Advisors, Inc. Member FINRA/SIPC. SEC-registered investment adviser.

Not all products and services are available in every state or location or through all entities within BMO or BMO Family Office. Securities, investment, and insurance products offered are: **NOT A DEPOSIT - NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY - NOT GUARANTEED BY ANY BANK - MAY LOSE VALUE.**

BMO and BMO Financial Group are trade names used by Bank of Montreal.

© 2019 BMO Financial Group. All rights reserved

C-11#8225721

Written: February 12, 2019